INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statute and Regulations involved	2
Statement	2
Argument	5
Conclusion	14
Appendix	15

CITATIONS

Cases:	
Baker v. *Commissioner*, 80 F. 2d 813	13
Barnes v. *United States*, 22 F. Supp. 282	13
Campbell v. *United States*, 144 F. 2d 177	13
Commissioner v. *Sansome*, 60 F. 2d 931, certiorari denied, 287 U. S. 667	4, 7, 9
Commissioner v. *Wheeler*, 324 U. S. 542	13
Corrigan v. *Commissioner*, 103 F. 2d 1010, certiorari denied, 308 U. S. 576	13
Cranson v. *United States*, 146 F. 2d 871, certiorari denied October 8, 1945	13
Crocker v. *Commissioner*, 29 B. T. A. 773	13
Geerday Enterprises v. *Commissioner*, 126 F. 2d 384	13
Harter v. *Helvering*, 79 F. 2d 12	13
McClintic, Estate of v. *Commissioner*, 47 B. T. A. 188	13
Murchison's Estate v. *Commissioner*, 76 F. 2d 641	13
Putnam v. *United States*, 149 F. 2d 721	13
Reed Drug Co. v. *Commissioner*, 130 F. 2d 288	13
Riverside Cement Co. v. *Rogan*, 59 F. Supp. 401	13
United States v. *Kauffmann*, 62 F. 2d 1045	13
Statutes:	
Internal Revenue Code:	
Sec. 115 (26 U. S. C. 115)	13
Sec. 717 (26 U. S. C. 717)	6
Sec. 718 (26 U. S. C. 718)	5, 6, 9, 15
Second Revenue Act of 1940, c. 757, 54 Stat. 974, Sec. 201	5
Miscellaneous:	
1945 Cumulative Pocket Supplement to 7A Mertens, Law of Federal Income Taxation, par. 42.116	11
H. Conference Rep. No. 3002, 76th Cong., 3d Sess., p. 49, (1940–2 Cum. Bull. 548)	9

710052—46——1

Miscellaneous—Continued Page

H. Rep. No. 2894, 76th Cong., 3d Sess., p. 25 (1940–2 Cum. Bull. 496) 9

1946 Prentice-Hall Federal Tax Service, par. 48,051A 11

S. Rep. No. 2114, 76th Cong., 3d Sess. (1940–2 Cum. Bull. 528):

P. 6 9

P. 10 ..... 8, 9

Treasury Regulations 103, Art. 115–11 13

Treasury Regulations 109, Sec. 30.718–6 ..... 11, 17

In the Supreme Court of the United States

OCTOBER TERM, 1946

No. 330

CROSSETT WESTERN COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 21a–31a) is reported at 4 T. C. 783. The opinion of the Circuit Court of Appeals (R. 32–39) is reported at 155 F. 2d 433.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on April 26, 1946. (R. 40.) The petition for a writ of certiorari was filed on July 26, 1946. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

In determining the taxpayer's equity invested capital in 1940 and 1941 for excess profits tax purposes, whether the earnings and profits, which were acquired by taxpayer in 1923 from other corporations in a non-taxable reorganization but which were subsequently eliminated by taxpayer's operating losses prior to 1940, are properly to be applied under Section 718 (b) (3) of the Internal Revenue Code in reduction of amounts included in equity invested capital under Section 718 (a) of the Code.

STATUTE AND REGULATION INVOLVED

The applicable statute and regulations are printed in the Appendix, *infra,* pp. 15–18.

STATEMENT

The stipulated facts (R. 4a–20a), as stated by the Tax Court (R. 22a–26a), may be summarized as follows:

The taxpayer is a Delaware corporation organized November 19, 1923, with principal office in Portland, Oregon. Its authorized capital stock was 10,000 shares of preferred stock of a par value of $100 per share and 90,000 shares of common stock of a par value of $100 per share. (R. 22a–23a.)

On November 23, 1923, a plan of reorganization was adopted by the taxpayer and three other corporations (hereinafter referred to as the "three

corporations"), whereby the three corporations were to be consolidated into the taxpayer, by conveying all of their net assets, except certain cash which was to be distributed to their respective stockholders, to the taxpayer solely in exchange for the taxpayer's stock. The plan of reorganization was carried out in accordance with its terms as of December 31, 1923. The three corporations exchanged the taxpayer's stock, which was received by them upon the consolidation, in redemption of all their own stock, and thereupon dissolved. (R. 23a.)

The taxpayer received the assets of the three corporations, pursuant to the plan of reorganization, without recognition of gain or loss under the internal revenue laws. The bases of the assets in the hands of the taxpayer were the same as their bases in the hands of the three corporations. (R. 23a.) The net unadjusted basis for determining loss upon sale or exchange of all the assets transferred to the taxpayer by the three corporations on December 31, 1923, after deducting the liabilities assumed by the taxpayer, was $3,644,-389.48. (R. 24a, 25a, 26a.)

For these assets the taxpayer issued to the three corporations shares of its common stock of a par value of $8,411,800 and preferred stock of a par value of $164,600. (R. 26a.)

One of the three corporations had no earnings and profits at the time it transferred its assets

to the taxpayer. (R. 24a.) The other two of the three corporations had earnings and profits totaling $923,180.51, which under the rule, of *Commissioner* v. *Sansome,* 60 F. 2d 931 (C. C. A. 2nd), certiorari denied, 287 U. S. 667, became earnings and profits of the taxpayer upon transfer of the assets of those corporations to it. (R. 24a, 25a.)

The taxpayer commenced operations on January 1, 1924, and from that date to and including December 31, 1939, the operations resulted in aggregate losses in excess of $923,180.51. The taxpayer had no accumulated earnings and profits either from its own operations or transferred to it by a predecessor corporation under the rule of *Commissioner* v. *Sansome, supra,* as of the beginning of either of the years 1940 or 1941. (R. 26a.)

In computing the amount of its equity invested capital for excess profits tax for 1940 and 1941, the taxpayer made no deductions in respect of the earnings and profits it had acquired from its transferor corporations. The Commissioner determined that such deductions were required by the provisions of Section 718 (b) (3) of the Internal Revenue Code and determined deficiencies accordingly. (R. 26a.)

The Tax Court affirmed this determination (R. 26a–30a) and the Circuit Court of Appeals also affirmed (R. 32–39).

ARGUMENT

The taxpayer does not assert that the judgment of the lower court is in conflict with any decision. Its reasons for seeking a writ of certorari (Pet. 6–7) are that the question involved is important and that the judgment is erroneous. The decision of the Circuit Court of Appeals is correct and we do not believe that the question decided is presently of such general importance as to warrant review by this Court.[1]

This case is concerned with the computation under Section 718 of the Internal Revenue Code (Appendix, *infra*) or the equity invested capital of the taxpayer for excess profits tax purposes.[2]

[1] We are advised by the Chief Counsel's office of the Bureau of Internal Revenue that its records indicate that there is but one other case pending before the Tax Court which presents the same question as does the instant case; and, further, that it is unable to find from the data available that any such cases are pending administratively in the Bureau of Internal Revenue itself.

[2] Section 201 of the Second Revenue Act of 1940, c. 757, 54 Stat. 974, added a new subchapter to the Internal Revenue Code imposing a graduated surtax on excess profits of corporations, commencing with the tax year 1940. The tax is laid on profits in excess of normal profits. The measure of the normal profits is either the average annual profits for a four year base period 1936–1939, inclusive, or a figure equal to 8% of the invested capital. The normal profits, determined in either way, are allowed as a credit against the excess profits net income (ordinary net income with certain adjustments) in arriving at the income subject to excess profits tax. This case involves the ascertainment of the normal profits by the invested capital method for purposes of com-

Section 718 (a) defines "equity invested capital" as the sum of money or property previously paid in for stock, or as paid-in surplus, or as a contribution to capital; previous distributions of stock which are considered distributions of earnings or profits; the accumulated earnings or profits at the beginning of the year; and certain other items. The sum of these amounts is to be reduced as provided in subsection (b). Insofar as material here, that section is as follows:

> (b) *Reduction in equity Invested Capital.*—The amount by which the equity invested capital for any day *shall be reduced* as provided in subsection (a) *shall be* the sum of the following amounts—
>
> * * * * *
>
> (3) *Earnings and profits of another corporation.*—The earnings and profits of another corporation which previously at any time were included in accumulated earnings and profits by reason of a transaction described in section 112 (b) to (e), both inclusive, or in the corresponding provision of a prior revenue law, or by reason of the transfer by such other corporation to the taxpayer of property the basis of which in the hands of the taxpayer is or was determined with reference to its basis in the hands of such other corporation, or would

puting the allowable 8% credit. Invested capital under Section 717 of the Internal Revenue Code is made up of "borrowed invested capital" and "equity invested capital," the latter of which is in question in this case.

> have been so determined if the property had been other than money; * * * (Italics supplied.)

Both the lower courts held (R. 26a–30a, 32–39) that this section contains no ambiguity and that its plain language requires that the taxpayer's equity invested capital for the years 1940 and 1941 "shall" be reduced by the amount of the earnings and profits of the three corporations, since these earnings became the taxpayer's earnings under the principle of *Commissioner* v. *Sansome,* 60 F. 2d 931 (C. C. A. 2nd), certiorari denied, 287 U. S. 667, in a non-taxable transaction such as is described in Section 112 (b).

(1) The taxpayer argues (Br. 10–15) that the unequivocal language of the statute does not reflect the Congressional intent as shown by the legislative history and that the words of the statute should be discarded in favor of the real intent, which does not require reduction of its equity invested capital by the earnings and profits acquired from the corporations.

The lower court (R. 35–39) painstakingly examined the legislative history relied on by the taxpayer in support of its contention that the intention was to require reduction of equity invested capital by the acquired earnings only to eliminate duplications, which resulted from the double inclusion in such capital of the predecessor's earnings under Section 718 (a), both as assets paid-in

710052—46——2

for stock and as accumulated earnings or profits at the beginning of the tax year. Its conclusion was that, although the Congressional committees unquestionably were concerned with a possible duplication of the same earnings in equity invested capital, the statute as ultimately enacted did not limit its command for reduction of invested capital to cases in which a duplication had occurred, and that it was not free to read such a limitation into the statutory language. As it pointed out (R. 37–38), if the original House Bill had been enacted, the present question might not have arisen. But the Senate changed the House provision materially[3] and the Conference Committee made further technical changes. Although all the committee reports contain statements indicating that the reason for the provision was to

[3] The House Bill originally provided in Section 718 (a) (4) that the accumulated earnings or profits at the beginning of the tax year be included in equity invested capital, and in Section 718 (c) (4) that the earnings or profits acquired from a transferor corporation be excluded from the accumulated earnings at the beginning of the year. The Senate deleted Section 718 (c) (4) of the House Bill and added Section 718 (b) (3) providing for the reduction of equity invested capital (as distinguished from reduction of the accumulated earnings) by the acquired earnings "previously at any time" included in accumulated earnings or profits. S. Rep. No. 2114, 76th Cong., 3d Sess., p. 14 (1940–2 Cum. Bull. 528, 539), stated that Section 718 was retained substantially as in the House Bill, except for certain clerical and technical changes, the most important of which was that Section 718 (c) (4) of the House Bill "has been inserted as section 718 (b) (3) and made an actual step in the computation."

avoid duplications of the earnings acquired from a predecessor in equity invested capital,[4] the Conference Committee stated that a provision inserted by it (with respect to liquidations of subsidiaries) enabled Section 718 (b) (3) "to be expanded so as to cover all situations in which, under the doctrine of *Commissioner* v. *Sansome* (60 F. (2d) 931), the earnings and profits of one corporation become the earnings and profits of another." H. Conference Rep. No. 3002, 76th Cong., 3d Sess., p. 49 (1940–2 Cum. Bull. 548, 555).

Thus, the language of Section 718 (b) (3), which is not restricted to cases where a corporation has accumulated earnings or profits at the beginning of the tax year,[5] reflects the Congres-

[4] H. Rep. No. 2894, 76th Cong., 3d Sess., p. 25 (1940–2 Cum. Bull. 496, 514); S. Rep. No. 2114, 76th Cong., 3d Sess., pp. 6, 10 (1940–2 Cum. Bull. 528, 532, 539); H. Conference Rep. No. 3002, 76th Cong., 3d Sess., p. 49 (1940–2 Cum. Bull. 548, 555).

[5] If Congress had intended such a limitation, Section 718 (b) (3) would have made an exception for the situation in which a corporation, like the taxpayer here, has no accumulated earnings or profits at the beginning of the taxable year by reason of having suffered losses in excess of the earnings acquired from a transferor corporation. Since H. Rep. No. 2894, *supra*, p. 25, stated in connection with Section 718 (a) (4) that a deficit in accumulated earnings or profits at the beginning of the year shall not be taken into account but the earnings at that time shall be zero for the purpose of computing the invested capital, it is clear that Congress anticipated the possibility that some corporations would have no accumulated earnings. Its failure to exclude corporations having deficits from the operation of Section 718 (b) (3) seems therefore intentional.

sional intent that it apply *in all cases* where a corporation has acquired earnings of a predecessor under the *Sansome* rule. This language, of course, is not at variance with the stated objective of preventing duplicate inclusions of a predecessor's earnings and profits in equity invested capital, since if all corporations affected reduce their invested capital as provided in Section 718 (b) (3), all cases of duplication will be eliminated.

Moreover, it is necessary to reduce equity invested capital even in the case of a deficit corporation, as provided in Section 718 (b) (3), in order to avoid an overstatement of such capital, as the concurring opinion of the Tax Court pointed out.[6] (R. 30a–31a.) See also fn. 3, R. 38.

---

[6] For example, here the amount of $3,644,389.48, included in equity invested capital as assets paid in for stock under Section 718 (a) (2), reflects $923,180.51 of accumulated earnings of the three corporations. (R. 7a, 9a.) Under Section 718 (a) (4) the same earnings would also have been reflected in the accumulated earnings and profits at the beginning of the taxable year if the taxpayer had not had subsequent operating deficits in excess of these earnings. Since the acquired earnings and profits had been lost, the accumulated earnings at the beginning of the taxable year had been automatically reduced to reflect this loss. However, the invested capital attributable to property paid in for stock was not reduced, or reducible *as such* under Section 718 (a) (2), when the assets corresponding to the acquired earnings were lost. Unless some further reduction is made, the equity invested capital will show an inflated amount for property paid in, consisting of earnings which are no longer there in the form of assets. In these circumstances, Section 718 (b) (3) is necessary to

Congress may well have phrased Section 718 (b) (3) in absolute terms in order to avoid a duplication of this kind, as well as the duplication inherent in the situation where the acquired earnings have not been lost.

It follows that both lower courts correctly decided that the precise language of Section 718 (b) (3) exactly reflects the Congressional intent. The administrative interpretation is in accord with this view. Section 30.718–6 of Treasury Regulations 109 (Appendix, *infra*) provides that the reduction of equity invested capital directed by Section 718 (b) (3) is to be made, regardless of the condition of the earnings and profits account immediately prior to or at any time subsequent to the date of the transaction in which the earnings were acquired.[7]

2. The taxpayer's second contention (Br. 15–22) is that as a matter of statutory construction

---

effect a reduction of equity invested capital to the extent that the earnings acquired from other corporations formerly represented by assets in the paid-in capital account have been lost. See Section 30.718–6 of Treasury Regulations 109.

[7] See also letter dated December 6, 1943, signed by the Deputy Commissioner of Internal Revenue, ruling that even though a corporation may have a deficit in accumulated earnings and profits at the beginning of the tax year, full reduction of equity invested capital by the earnings and profits acquired from a predecessor is to be made under Section 718 (b) (3). This letter is printed at Paragraph 42.116 (p. 174) of the 1945 Cumulative Pocket Supplement to 7A Mertens, Law of Federal Income Taxation, and at Paragraph 48,051–A of the 1946 P–H Federal Tax Service.

apart from Congressional intent, Section 718 (b) (3) should be read to require a reduction of equity invested capital only by (Br. 16)—

> the earnings and profits of another corporation which previously at any time were included in accumulated earnings and profits *as of the beginning of the taxable year* * * *.

Thus, it would add the italicized phrase to the statutory language, but as the lower court pointed out (R. 39), this is an attempt to reconstruct the section by adding a condition which is contrary to the usual and accepted sense of the phrase "previously at any time." The statute in its natural sense refers to the earnings and profits of another corporation which were included in the accumulated earnings and profits of the taxpayer at any previous time, and not in its accumulated earnings at the beginning of the taxable year. We submit that there is no basis whatever for disregarding the plain meaning of the language actually used in favor of a far-fetched and awkward interpretation. The legislative history reveals nothing which would support the taxpayer's suggested construction.

Taxpayer also suggests (Br. 18) that Section 718 (b) (3) applies only where a corporation has elected to include in its own earnings the earnings acquired from another corporation. But a taxpayer has no election in this matter. Under the *Sansome* principle, which has been uniformly

applied,[8] where assets are transferred in a nontaxable reorganization in exchange for stock, the predecessor's earnings included in those assets are inherited by and become the earnings of the acquiring corporation as a matter of law. In any case, it was stipulated here that the earnings and profits of two predecessor companies became the taxpayer's earnings and profits under the *Sansome* rule. (R. 6a–8a.) Application of this principle does not result in treating the taxpayer as a mere continuance of its predecessors, as taxpayer argues. (Br. 20–21.)

[8] *Putnam* v. *United States*, 149 F. 2d 721 (C. C. A. 1st); *Reed Drug Co.* v. *Commissioner*, 130 F. 2d 288 (C. C. A. 6th); *Georday Enterprises* v. *Commissioner*, 126 F. 2d 384 (C. C. A. 4th); *Corrigan* v. *Commissioner*, 103 F. 2d 1010 (C. C. A. 3d), certiorari denied, 308 U. S. 576; *Baker* v. *Commissioner*, 80 F. 2d 813 (C. C. A. 2d); *Harter* v. *Helvering*, 79 F. 2d 12 (C. C. A. 2d); *Murchison's Estate* v. *Commissioner*, 76 F. 2d 641 (C. C. A. 5th); *United States* v. *Kauffmann*, 62 F. 2d 1045 (C. C. A. 9th); *Barnes* v. *United States*, 22 F. Supp. 282 (E. D. Pa.); *Riverside Cement Co.* v. *Rogan*, 59 F. Supp. 401 (S. D. Cal.); *Crocker* v. *Commissioner*, 29 B. T. A. 773; *Estate of McClintic* v. *Commissioner*, 47 B. T. A. 188; Article 19115–11 of Treasury Regulations 103, promulgated under the Internal Revenue Code. See *Commissioner* v. *Wheeler*, 324 U. S. 542, 546. See also Section 115 (h) of the Internal Revenue Code which incorporates the principle. A deficit of a transferor, however, does not carry over to the corporation which acquires the transferor's assets. *Cranson* v. *United States*, 146 F. 2d 871 (C. C. A. 9th), certiorari denied October 8, 1945. *Campbell* v. *United States*, 144 F. 2d 177 (C. C. A. 3d), alone held that the *Sansome* principle was not applicable under the peculiar facts of that case, but as the lower court pointed out (R. 33, fn. 1), that decision has no bearing here.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

J. HOWARD MCGRATH,
Solicitor General.
DOUGLAS W. MCGREGOR,
Assistant Attorney General.
SEWALL KEY,
HELEN R. CARLOSS,
HELEN GOODNER,
Special Assistants to the Attorney General.

AUGUST 1946.

APPENDIX

Internal Revenue Code:

SEC. 718 [added by Sec. 201, Second Revenue Act of 1940, c. 757, 54 Stat. 974]. EQUITY INVESTED CAPITAL.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

(1) *Money paid in.*—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

(2) [as amended by Sec. 218, Revenue Act of 1942, c. 619, 56 Stat. 798]. *Property paid in.*—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. If the property was disposed of before such taxable year, such basis shall be determined under the law applicable to the year of disposition, but without regard to the value of the property as of March 1, 1913. If the property was disposed of before March 1, 1913, its basis shall be considered to be its fair market value at the time paid in. If the unadjusted basis of the property is a substituted basis, such basis shall be adjusted, with respect to the period before the property was paid in, by an amount equal to the adjustments proper under section

earnings and profits as of the beginning of the taxable year. Thus, if the transaction is a reorganization to which section 113 (a) (7) is applicable, and in which the taxpayer receives all the assets of another corporation in exchange solely for its own stock, such amount has already been taken into account in property paid in for stock under section 718 (a) (2); or if the transaction is an intercorporate liquidation of another corporation involving a distribution with respect to stock of such other corporation held by the taxpayer with a basis determined under section 761 to be a basis other than cost, such amount has already been taken into account in the computation of equity invested capital of the taxpayer, as adjusted under section 761 (d) (2).

To preclude this duplicate inclusion of the earnings and profits of another corporation in the invested capital of the taxpayer, section 718 (b) (3) provides, as a step in the computation of equity invested capital, for the reduction of equity invested capital otherwise computed by the amount of earnings and profits of another corporation previously at any time included in the earnings and profits of the taxpayer. This adjustment is to be made in the computation of equity invested capital for each day after the day of such transaction, regardless of whether the earnings and profits absorbed were produced during the taxable year of the taxpayer in which such transaction occurred or in a prior taxable year, and regardless of the condition of the earnings and profits account of the taxpayer immediately prior to or at any time subsequent to the date of such transaction.

* * * * *

U. S. GOVERNMENT PRINTING OFFICE: 1946